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Memorandum

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subject: Cost segregation studies and interest capitalization under 263A(f)

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LEGEND

Taxpayer =
X =

ISSUES

1. Whether property classified as depreciable tangible personal property for purposes of § 168 can ever constitute "real property" (as defined in § 1.263A-8(c)), rather than "tangible personal property" (as defined in § 1.263A-2(a)(2)) for purposes of determining capitalized interest using the avoided cost method under § 263A(f).

2. In calculating capitalized interest using the avoided cost method under § 263A(f), whether the portion of the cost of an electrical or plumbing system of a building that is allocable to depreciable tangible personal property for purposes of § 168 is included in

the accumulated production expenditures of the real property in which such system is installed.

CONCLUSIONS

1. Property classified as depreciable tangible personal property for purposes of § 168 can be either real property or tangible personal property for purposes of the avoided cost interest capitalization calculation under § 263A(f); such determination is made under the principles of § 263A(f) and the regulations thereunder, and is not controlled by the characterization of property for purposes of § 168.
2. The portion of the cost of an electrical or plumbing system of a building that is allocable depreciable tangible personal property for purposes of § 168 is not excludable from the accumulated production expenditures of the real property in which the system is installed.

FACTS

Taxpayer, an international operator of retail stores, made tenant improvements to X of its leased stores ("the stores"). The scope of the improvements made to each particular store depended upon the specifications of the lease. The improvements included such items as the demolition of existing tenant improvements, floor and wall prep, electrical rough-in and retrofit, new or tie-in to existing HVAC, interior framing, restroom remodel and construction, finish electrical and lighting installation, drywall, suspended acoustical ceiling installation, paint, finish millwork and storefront construction, acoustical t-bar ceilings, installation of concrete, wood, carpet and resilient flooring, security, music, telephone and data systems, and casework and hardware for shelving.

Taxpayer retained a public accounting firm to conduct a cost segregation analysis of tenant improvements made by taxpayer at the stores. The stated objectives of this analysis were to identify property that qualified as depreciable tangible personal property and depreciable land improvements versus depreciable real property other than land improvements, to identify and isolate the actual construction costs associated with each property unit, and to assign the appropriate class life to each property unit for purposes of depreciation under § 168, the Modified Accelerated Cost Recovery System (MACRS). As a result of this cost segregation analysis, various costs that had previously been classified as depreciable real property other than land improvements were recharacterized, for purposes of § 168, as depreciable tangible personal property or depreciable land improvements.

Some of the costs recharacterized by the cost segregation analysis related to property that the analysis described as "dual-function components" of a building. The cost segregation analysis argues that these dual-function components, which include electrical wiring and plumbing, provide services relating both to building functions (such as general lighting or restrooms) and to equipment or process functions (such as equipment hookups and waste drains). Accordingly, the cost segregation analysis

allocates the costs of dual-function property between depreciable real property other than land improvements and depreciable tangible personal property.

Taxpayer capitalized interest with respect to its tenant improvements using the avoided cost method under § 263A(f) and the regulations thereunder (§§ 1.263A-8 thru 1.263A-15, the "avoided cost method regulations"). After receiving the cost segregation analysis, taxpayer removed from the accumulated production expenditures (APEs) of the stores all of the costs which were recharacterized from depreciable real property other than land improvements to depreciable tangible personal property.

LAW AND ANALYSIS

Issue 1:

Section 263A(f)(1) provides that § 263A(a) shall only apply to interest costs which are: (A) paid or incurred during the production period; and (B) allocable to real or tangible personal property produced by the taxpayer that has a long useful life, has an estimated production period exceeding two years, or has an estimated production period exceeding one year with a cost exceeding \$1,000,000. Section 263A(f)(4)(A) provides that property has a long useful life if such property is real property or property with a class life of 20 years or more (as determined under § 168).

Section 1.263A-8(c)(1) provides that real property includes land, unsevered natural products of land, buildings, and inherently permanent structures. Real property includes the structural components of buildings and inherently permanent structures, such as walls, partitions, doors, wiring, plumbing, central air conditioning and heating systems, pipes and ducts, elevators and escalators, and other similar property.

Section 1.263A-8(c)(3) provides that inherently permanent structures include property that is affixed to real property and that will ordinarily remain affixed for an indefinite period of time, such as swimming pools, roads, bridges, tunnels, paved parking areas and other pavements, special foundations, wharves and docks, fences, inherently permanent advertising displays, inherently permanent outdoor lighting facilities, railroad tracks and signals, telephone poles, power generation and transmission facilities, permanently installed telecommunications cables, broadcasting towers, oil and gas pipelines, derricks and storage equipment, grain storage bins and silos. Property may constitute an inherently permanent structure even though it is not classified as a building for purposes of former §§ 48(a)(1)(B) and 1.48-1. Any property not otherwise described in § 1.263A-8(c)(3) that constitutes other tangible property under the principles of former §§ 48(a)(1)(B) and 1.48-1(d) is treated for the purposes of § 1.263A-8 as an inherently permanent structure.

Section 168(i)(12) provides that the terms "section 1245 property" and "section 1250 property" have the meanings given such terms by §§ 1245(a)(3) and 1250(c), respectively.

Section 1245(a)(3) (as in effect before 2003) provides that the term "section 1245 property" means any property which is or has been property of a character subject to the allowance for depreciation provided in § 167 and is either: (A) personal property; (B) other property (not including a building or its structural components) but only if such other property is tangible and is used as an integral part of manufacturing, production, or extraction or of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services, or constituted a research facility, or a bulk storage facility of fungible commodities, used in conjunction with any of the foregoing activities; (C) so much of any real property (other than any property described in subparagraph (B)) which has an adjusted basis in which there are reflected adjustments for amortization under § 169, 179, 179A, 185, 188 (as in effect before its repeal by the Revenue Reconciliation Act of 1990), 190, 193, or 194; (D) a single purpose agricultural or horticultural structure (as defined in § 168(i)(13)); (E) a storage facility (not including a building or its structural components) used in connection with the distribution of petroleum or any primary product of petroleum; or (F) any railroad grading or tunnel bore (as defined in § 168(e)(4)).

Section 1.1245-3(b) provides that the term "personal property" means (1) tangible personal property (as defined in § 1.48-1(c), relating to the definition of "section 38 property" for purposes of the investment credit), and (2) intangible personal property.

Section 1.48-1(c) provides that the term "tangible personal property" means any tangible property except land and improvements thereto, such as buildings or other inherently permanent structures (including items which are structural components of such buildings or structures). Thus, buildings, swimming pools, paved parking areas, wharves and docks, bridges, and fences are not tangible personal property. Tangible personal property includes all property (other than structural components) which is contained in or attached to a building. Thus, such property as production machinery, printing presses, transportation and office equipment, refrigerators, grocery counters, testing equipment, display racks and shelves, and neon and other signs, which is contained in or attached to a building constitutes tangible personal property. Further, all property which is in the nature of machinery (other than structural components of a building or other inherently permanent structure) shall be considered tangible personal property even though located outside a building. Thus, for example, a gasoline pump, hydraulic car lift, or automatic vending machine, although annexed to the ground, shall be considered tangible personal property.

Section 1.48-1(c) further provides that local law shall not be controlling for purposes of determining whether property is or is not "tangible " or "personal." Thus, the fact that under local law property is held to be personal property or tangible property shall not be controlling, and that property may be personal property for purposes of the investment credit even though under local law the property is considered to be a fixture and therefore real property.

Section 1.48-1(e)(2) provides that the term "structural components" includes such parts of a building as walls, partitions, floors, and ceilings, as well as any permanent coverings therefor such as paneling or tiling; windows and doors; all components (whether in, on, or adjacent to the building) of a central air conditioning or heating system, including motors, compressors, pipes and ducts; plumbing and plumbing fixtures, such as sinks and bathtubs; electric wiring and lighting fixtures; chimneys; stairs, escalators, and elevators, including all components thereof; sprinkler systems; fire escapes; and other components relating to the operation or maintenance of a building. However, the term "structural components" does not include machinery the sole justification for the installation of which is the fact that such machinery is required to meet temperature or humidity requirements which are essential for the operation of other machinery or the processing of materials or foodstuffs. Machinery may meet the "sole justification" test provided by the preceding sentence even though it incidentally provides for the comfort of employees, or serves, to an insubstantial degree, areas where such temperature or humidity requirements are not essential.

In Hospital Corporation of America v. Commissioner, 109 T.C. 21 (1997) ("HCA"), the Tax Court concluded that tests developed for purposes of the investment credit ("ITC") under former § 48 could be used by taxpayers to distinguish section 1245 property from section 1250 property for purposes of § 168. Consequently, depreciable property that would have qualified as tangible personal property for ITC purposes also will qualify as section 1245 property for depreciation purposes. *Id.* at 55.

By contrast, the legislative history of § 263A(f), contains nothing to indicate that Congress intended the broad construction of tangible personal property under the ITC to apply to interest capitalization under § 263A(f). Accordingly, the classification of property as tangible personal property for purposes of former § 48 should not be determinative of the classification of property as tangible personal property for purposes of § 263A(f). Preamble, T.D. 8584, 1995-1 C.B. 20, 22. Thus, the fact that electrical lines within a building might be classified, in whole or in part, as tangible personal property for purposes of the definition of § 1245 property does not determine whether these lines are tangible personal property or real property for purposes of § 263A(f).

From the foregoing, it follows that the principles and tests used to determine whether an item of property is tangible personal property under § 1.48-1(c) (and thus to determine whether the item qualifies as section 1245 property) do not apply in determining whether such item of property is tangible personal property or real property for purposes of § 263A(f). For example, the principle that the classification of property under local law is irrelevant to the classification of property for purposes of the ITC (and section 1245 property) does not apply to the classification of property under § 263A(f). In the absence of any applicable legislative direction to ignore the status of property under local law in the context of § 263A(f), we believe that the local law characterization of an item of property can be a relevant consideration in the classification of property as either tangible personal property or real property for purposes of § 263A(f).

As a further example, under the ITC classification of property, a number of courts have concluded that an item of property, even if listed in § 1.48-1(e)(2), is not a structural component of a building to the extent that the item does not relate to the operation or maintenance of the building. See, e.g., Scott Paper Co. v. Commissioner, 74 T.C. 137 (1980); HCA; but see Boddie-Noell Enterprises, Inc. v. United States, 36 Cl. Ct. 722 (1996). As a result, even though wiring is an example under § 1.48-1(e)(2), some courts have allocated the cost of electric wiring based on its ultimate use: the portion of the wiring representing the electrical load necessary for the operation of, and used directly with, particular pieces of machinery within the building, is tangible personal property, and the portion of wiring representing the electrical load related to the operation or maintenance of the building is a structural component. See, e.g., Scott Paper Co.; HCA.

As discussed above, the foregoing test does not control the classification of property under § 263A(f). In the absence of such a controlling test, an item of property that does not qualify as a structural component under the ITC scheme because it does not relate to the operation or maintenance of a building may well constitute a structural component of the building, and thus real property, under § 1.263A-8(c) if the property otherwise possesses sufficient indicia of being a structural component under that regulation, such as being described as such within § 1.263A-8(c), being permanently attached, and qualifying as a fixture under local law. For example, electrical wiring in a building could qualify as a structural component under § 1.263A-8(c) regardless of its ultimate use.

Finally, we note that just as the classification of property for purposes of § 168 does not control the classification of the property for purposes of § 263A(f), the classification of the property for purposes of § 263A(f) does not control its classification for purposes of cost recovery under § 168. Interest capitalized under § 263A(f) is treated as a cost of the designated property produced, and is recovered through depreciation, amortization, cost of goods sold, or an adjustment to basis at the time the property is used, sold, placed in service, or otherwise disposed of by the taxpayer. Cost recovery is determined by the applicable Code and regulatory provisions relating to the use, sale, or disposition of property. §§ 1.263A-1(c)(4) and 1.263A-8(a)(2).

The regulations further provide that interest capitalized with respect to the produced designated property that includes both components subject to an allowance for depreciation or depletion and components not subject to an allowance for depreciation or depletion is ratably allocated among, and is treated as a cost of, components that are subject to an allowance for depreciation or depletion. § 1.263A-8(a)(2). We believe that this principle of ratable allocation applies equally well to interest capitalized with respect to the produced designated property that includes only components subject to an allowance for depreciation.

Accordingly, interest capitalized under § 263A(f) with respect to a unit of designated property is ratably allocable to the components of property comprising the unit. Thus, interest capitalized with respect to items classified as tangible personal property under

the definition of section 1245 property would be allocated to such property, and would be depreciated under the Code and regulatory provisions applicable to such property.

ISSUE 2

Section 1.263A-8(c)(1) provides in part that real property includes land, unsevered natural products of land, buildings, and inherently permanent structures. Any interest in real property of a type described in § 1.263-8(c), including fee ownership, co-ownership, a leasehold, an option, or a similar interest, is real property under § 1.263A-8. Real property includes the structural components of both buildings and inherently permanent structures, such as walls, partitions, doors, wiring, plumbing, central air conditioning and heating systems, pipes and ducts, elevators and escalators, and other similar property. Tenant improvements to a building that are inherently permanent or otherwise classified as real property within the meaning of § 1.263A-8(c)(1) are real property under § 1.263A-8.

Section 1.263A-10(a) provides in part that the unit of property as defined in § 1.263A-10 is used as the basis to determine accumulated production expenditures under § 1.263A-11 and the beginning and end of the production period under § 1.263A-12.

Section 1.263A-10(b)(1) provides in part that a unit of real property includes any components of real property owned by the taxpayer or a related person that are functionally interdependent and an allocable share of any common feature owned by the taxpayer or a related person that is real property even though the common feature does not meet the functional interdependence test.

Section 1.263A-10(b)(2) provides in part that components of real property produced by, or for, the taxpayer, for use by the taxpayer or a related person are functionally interdependent if the placing in service of one component is dependent on the placing in service of the other component by the taxpayer or a related person.

The cost segregation analysis identifies plumbing and electrical distribution systems of a building as two examples of “dual-function” properties whose costs are allocable between depreciable tangible personal property and depreciable real property other than land improvements for purposes of cost recovery. Taxpayer recharacterized a portion of its costs for plumbing and electrical distribution systems from depreciable real property other than land improvements to depreciable tangible personal property on the basis of the allocations developed in the cost segregation analysis. Taxpayer also removed these recharacterized costs from the APEs of the stores. As indicated above, however, the fact that costs are characterized as depreciable tangible personal property for purposes of § 168 is not sufficient in itself to establish that these costs do not constitute real property for purposes of capitalizing interest under § 263A(f). The determination whether costs constitute real property for purposes of interest capitalization must be made using the standards of § 263A(f) and the regulations thereunder.

Section 1.263A-8(c)(1) provides that real property includes the structural components of both buildings and inherently permanent structures, such as walls, partitions, doors, wiring, plumbing, central air conditioning and heating systems, pipes and ducts, elevators and escalators, and other similar property. Thus, plumbing and electrical distribution systems are expressly identified as constituting real property for purposes of § 263A(f).

The placing of a building into service is dependent upon placing its plumbing and electrical distribution systems into service, and vice versa. Plumbing and electrical distribution systems are thus functionally interdependent with the building in which they are installed (§ 1.263A-10(b)(2)). A building and its plumbing and electrical distribution systems are thus part of the same unit of real property for purposes of determining APEs and performing avoided cost calculations. § 1.263A-10(a), (b)(1). Thus, the entire cost of plumbing and electrical distribution systems installed in a unit of real property should be included in the APEs of the unit. As discussed above, the fact that some portion of these costs might qualify for treatment as depreciable tangible personal property for purposes of § 168 is not relevant.

In addition to the foregoing provisions, we note that excluding the costs allocated to depreciable tangible personal property from the APEs of the stores is inconsistent with the spirit of the overall property classification scheme of the avoided cost regulations in two significant respects.

First, removing the costs allocable to depreciable tangible personal property from the APEs of the stores implies that the cost of a plumbing or electrical system should be split between the APEs of a unit of real property (the building itself) and the APEs of a unit of tangible personal property (which would presumably be below the threshold for interest capitalization on tangible personal property). This analysis would be flatly inconsistent with the functional interdependence test for units of property, whether real property (§ 1.263A-10(b)(2)) or tangible personal property (§ 1.263A-10(c)). Splitting the cost of a plumbing or electrical system into depreciable tangible personal property and depreciable real property other than land improvements is essentially a cost accounting allocation; it has little or nothing to do with whether the two resulting components are functionally independent. In fact, the portion of a plumbing or electrical system of a building allocable to depreciable tangible personal property is generally undifferentiated from, and thus is functionally interdependent with, the portion allocable to depreciable real property other than land improvements. Accordingly, splitting a plumbing or electrical system into two units of property for purposes of § 263A(f) would be contrary to the functional interdependence test underlying the concept of unit of property in the avoided cost regulations.

Second, the avoided cost regulations contemplate two types of property: real property (defined in § 1.263A-8(c)) and tangible personal property (defined in § 1.263A-2(a)(2)). Components of property combine into units of property (defined in § 1.263A-10), which

are used to perform the avoided cost calculations. The regulations provide that real property components may combine into a single property unit (§ 1.263A-10(b)(1)), and that tangible personal property components may combine into a single property unit (§ 1.263A-10(c)). No provision is made, however, for real property components and tangible personal property components combining into a single property unit.

Accordingly, a unit of property under § 1.263A-10 must either be a real property unit (consisting entirely of real property components) or a tangible personal property unit (consisting entirely of tangible personal property components).

Allocating the cost of a plumbing or electrical system of a building between the APEs of a unit of real property and the APEs of a unit of tangible personal property is inconsistent with the spirit, if not the letter, of these provision. Such an allocation implies that a component of property can be both real property and tangible personal property, a result not contemplated by the avoided cost regulations.

Accordingly, the avoided cost regulations preclude taxpayer from excluding the costs of plumbing and electrical systems allocable to depreciable tangible personal property from the APEs of the stores. This conclusion and the foregoing analysis also apply to other structural components that might be treated as “dual-function property” in the cost segregation analysis, such as central air conditioning and heating systems and pipes and ducts. Such property is also functionally interdependent with the building in which it is installed, and constitutes part of the same unit of real property for purposes of § 263A(f) calculations.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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